# Citizens Finance Review Commission



# Analysis of Alternative Minimum Tax for Corporate Income Tax

**Prepared for the Citizens Finance Review Commission**

**by**

**Income Tax Research Committee**
**Anne Mariucci, Chair**

**and**

**Authors:**
**James Barash, Manager at KPMG LLP**
**Patrick Derdenger, Partner of Steptoe & Johnson LLP**
**Barbara Dickerson, Director at Deloitte & Touche LLP**
**David Downs, Principal Tax Analyst of Salt River Project**
**Amy Etzkorn, Assistant Vice President Tax of AdvancePCS**
**Karen Jacobs, Senior Economist of the Department of Revenue**
**Georganna Meyer, Chief Economist of the Department of Revenue**
**Dana Naimark, Assistant Director of the Children's Action Alliance**
**Susan Kimsey Smith, Esq. of Olsen-Smith, Ltd.**

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## Critical Reviewers:

Dan Anderson
Assistant Executive Director for Institutional Analysis
Arizona Board of Regents

Catherine F. Connolly
Executive Director
League of Arizona Cities and Towns

Dennis Hoffman, Ph.D.
Associate Dean, Graduate Programs
W. P. Carey MBA
Arizona State University

Elliott D. Pollack
President
Elliott D. Pollack & Co.

Jim Rounds
Economist
Elliot D. Pollack & Co.



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1. **What it is**:

Every corporation subject to the Arizona Income Tax Act of 1978 that engages in a trade or business or has income from the state must file an Arizona corporate income tax return. This includes C-corporations and Limited Liability Companies (LLC) classified as corporations. C-corporations and LLCs file Form 120 income tax return.

Currently, the net income of Arizona corporate taxpayers is subject to a regular income tax rate of 6.968%. Arizona does not have an alternative minimum income tax.

For federal income tax purposes, an alternative minimum tax (AMT) must be considered. Certain corporations are required to recompute taxable income based on a variety of adjustments and preferences to determine the alternative minimum taxable income (AMTI). Examples of the adjustments and preferences are accelerated depreciation, long-term contracts, installments sales, passive activities, depletion, and intangible drilling costs. The AMTI exceeding the $40,000 exemption is subject to 20% alternative minimum tax (AMT). This tax amount is then compared to the regular income tax. If the AMT exceeds the regular tax, the corporation must pay the excess as an alternative minimum tax in addition to the regular tax amount. The federal AMT concept is to collect some taxes from corporations that have book income but through certain preferential tax deductions (such as accelerated depreciation) have been able to significantly reduce their taxable income and thus reduce or eliminate their tax liability. Federal exempts "small" corporations from paying AMT. A small corporation has average gross receipts of the prior 3 tax year periods of less than $7.5 million.

In addition, for federal income tax purposes, alternative minimum tax requires other computations due to the interplay of net operating losses and credits. This adds significant complexity to the tax system. Alternative minimum tax is designed to accelerate the payment of corporate income taxes. In years subsequent to the payment of AMT, the taxpayer may be allowed a reduction to its regular tax liability in the amount of the AMT paid in a prior year. In these circumstances, AMT is not an increase to total taxes paid over the life of the corporation only a timing difference of when the tax is paid.

A corporation generally is an organization formed under state, federal or foreign corporation laws, having shareholders, directors, officers and limited liability. A corporation is an entity distinct from its shareholders. How a corporation is taxed depends on whether it is a C-corporation or an S-corporation. A C-corporation is any corporation that is not an S-corporation. C-corporations are subject to income tax on their taxable net income.

An eligible corporation may elect to be taxed as an S-corporation. Pass-through of tax attributes and limited liability are available to S-corporations. An S-corporation is generally exempt from federal and Arizona corporate level income tax. Instead, the corporation's income, loss, deduction and credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities. S-corporations are subject to many restrictions, including restrictions on the number and kind of shareholders, which do not apply to limited liability companies.

Limited liability companies (LLCs) are a creation of state law. LLCs are owned by members, who aren't personally liable for the LLC's debts or obligations. Under the federal “check-the-box” entity classification rules, if an LLC isn't mandatorily classified as a corporation, it may elect to be classified for tax purposes either as a partnership or as a corporation. If an LLC is characterized as a corporation for federal tax purposes, the limited liability company will be treated as a corporation for Arizona income tax purposes since Arizona conforms to federal. A single member LLC is an exception. A single member LLC, if it does not elect to be treated as corporation, is treated as not having any entity status (a disregarded entity). A single member LLC treated as a disregarded entity is not subject to filing a tax return and included in the members return like a division or branch.

The proposal before this commission is applying an Arizona alternative minimum tax to adjusted net income of corporations. This proposal assumes that Arizona will follow (piggyback) federal provisions and computations.

2. **How it would be administered**:

The alternative minimum tax is collected with the filing of the corporate income tax return, quarterly estimated tax payments or the filing of an extension by the original due date of the return. The tax is transmitted either by check or electronic funds transfer to the State. It is collected no differently than the regular corporate income tax.

The AMT would be calculated and determined by each taxpayer on its corporate income tax return, Form 120. An additional form would be created to facilitate the reporting and determination of the tax. The alternative minimum taxable income (AMTI) determination can start with federal amounts and then have Arizona additions and subtractions to income made.

The administration process would be incorporated with the filing of the corporate income tax return.

3. **Impact on Existing Revenue Systems**:

We do not expect the application of the alternative minimum tax to directly affect other revenue systems.

It may have a secondary affect on other current revenue sources, as it will increase business expense. This could effect dividend distributions or other business investments and expenditures.

Income tax revenues flow into the state’s general fund and are shared with cities and towns. An increase in revenue due the application of an alternative minimum tax (AMT) on C-corporations and LLCs classified as corporations, will increase the shared revenue to the cities and towns.

4. **Cost**:

The cost of administering the alternative minimum corporate tax would be modest because the mechanisms for collecting and processing the tax are already in place for the regular corporate income tax. The current processes would be enhanced to accommodate the additional tax.

There will be costs to develop a new AMT form and to redesign the current forms to accommodate the tax. Instruction changes and education of a new tax would also need to be made. The Department of Revenue's computer system may need to be modified to track, process and administer alternative minimum tax.

We believe the compliance cost to corporate taxpayers will increased. The taxpayer will need to calculate the tax not only for the tax return but also for quarterly estimated tax payments to avoid any underpayment penalties. This may require modifications to commercial tax preparation software or in-house templates. The remittance of the tax remains the same as for the regular tax. Taxpayers will need to track the Arizona adjustments, preferences, credits and net operating loss that are effected.

Should Arizona deviate from the federal approach, the cost to administer the tax and the cost for the taxpayer to comply will increase significantly. One such costly item will be the system need to track depreciable assets under another system.

5. **Policy Considerations**:

**A. Equity**

Alternative minimum tax is not evenly applied across all corporate taxpayers in horizontal equity. Taxpayers that are in businesses that have the "preferential" tax deductions or have a net operating loss carryforward would pay tax where their counterparts with the same amount of income and expenses in a different line of business would not. A dual system of taxation would decrease horizontal equity. The federal AMT system has produced some unintended negative results. The federal trend is to reduce or eliminate the AMT system.

Some argue that horizontal equity is improved as the federal tax code allows some corporations to reduce taxable income with deductions or credits available to certain types of business such as accelerated depreciation. They argue that accelerated depreciation deduction is not equitable. They claim the intent of the federal alternative minimum tax is to correct these perceived equity problems in the regular corporate income tax system.

The tax can have some vertical equity if corporations with book net income (those with the where withal to pay) pay some tax when net taxable income is eliminated by "preferential" deductions. To reduce the burden on small corporate taxpayers and those with small AMTI, an exemption amount such as the federal exemption of first $40,000 of taxable income not subject to the tax could be included.

### B. Economic Vitality

California and Florida are the two states among the 10 comparison states to apply an alternative minimum tax. The California AMT rate is 6.65% and Florida AMT rate is 3.3%. Each uses the federal method as a blue print in determining the state AMTI.

### C. Volatility

The level of revenue raised by the corporate alternative minimum tax is likely to be volatile as it is subject to economic swings, net profits, depreciable assets or other business climate factors as it relates to the amount of regular income tax. The adjustments and preference items are timing differences. Accelerated depreciation, as an example, pushes deductions into the earlier years of the life of the asset. For AMT purposes, those deductions still occur but over a longer live. In addition, a taxpayer can claim an AMT tax credit in years when its regular tax exceeds AMT. Again, it is more of a timing difference of when the tax is paid than a complete disallowance of an expense item. This may cause more volatility since AMT will effect multiple tax years. There is insufficient data to accurately reflect the volatility.

Some argue that volatility of tax collection will be reduced. An alternative minimum tax would set a floor which tax payments would fall as preference item deductions are designed to smooth out the mismatch of the book and income tax accounting methods.

### D. Simplicity

We believe the application of the corporate alternative minimum tax is difficult and adds overall an additional level of complexity to the corporate income tax process with a dual system. The current federal trend is to reduce the number of taxpayers affected by AMT. Arizona could parallel the federal approach which will lessen the impact. There still would require Arizona additions, subtraction and adjustments when using the federal computation as the starting point. Also, there may need to be a phase in period for the adjustments due to nature of some of the deductions.

Should Arizona deviate from the federal approach, the complexity increases significantly.

6. **Economic Impact**:

There is insufficient Arizona data to determine the revenue impact.

California applies an alternative minimum tax that mostly parallels the federal approach. The California AMT rate is 6.65 percent compared to its regular tax rate of 8.84% (for banks and financial corporations the AMT rate is 8.65 percent compared to the regular bank tax rate of

10.84%). For the 2000 tax year, 2,218 corporations out of a total 311,424 corporate returns filed (or a total of 0.7% of the returns) paid CA AMT. The total CA AMT paid of $109.1 million or 2% of total corporate tax collections of $5,376 million.

7. **Other**:

Arguments for applying an alternative minimum tax are the following:

- Corporations with book income will pay at least some corporate income tax.
- The new tax can be incorporated into the existing corporate income tax process and filings.
- The alternative minimum taxable income determination can be a piggyback from the federal calculation.

Arguments against applying an alternative minimum tax are as follows:

- The minimum tax would exceed all comparison states except for California and Florida.
- This parallel tax system is overall complex and is not business friendly to capital-intensive industries.
- The federal trend is to reduce the number of taxpayers subject to the tax.
- The revenue may be more volatile.